

**Section 25106.5 is amended to read:**

**§25106.5**

(See Section 25106.5-0 of the California Code of Regulations for the table of contents for this section, and all other regulations adopted under Section 25106.5 of the California Revenue and Taxation Code.)

(a) In general. Each taxpayer whose income and apportionment factor data are permitted or required to be included in a combined report shall report income in the manner provided by this regulation, and, to the extent applicable, other regulations adopted under Section 25106.5 of the Revenue and Taxation Code.

(b) Definitions. Unless otherwise indicated, the following definitions shall apply to all regulations adopted under Section 25106.5 of the Revenue and Taxation Code.

(1) "Combined report" refers to the schedules which are attached to the tax return, required to be filed by Section 18601 of the Revenue and Taxation Code, of one or more taxpayer members, which reports the taxpayer member's income from sources within this state under the combined reporting method.

(2) "Combined reporting method" refers to the method under which the total combined report business income of all members of the combined reporting group is apportioned to California, to determine each taxpayer member's combined report business income from California sources.

(3) "Combined reporting group" refers to those corporations with business income that is permitted or required to be included in a particular combined report under Sections 25101, 25101.15, 25102, or 25104 of the Revenue and Taxation Code, limited, if applicable, by application of Section 23801(c) of the Revenue and Taxation Code, or the effects of a water's edge election under Section 25110 of the Revenue and Taxation Code, or any other provision of law which precludes income and apportionment data of an entity from being included in a combined report. A combined reporting group also refers to those S Corporations whose income is required to be included in a combined report under Section 23801(d) of the Revenue and Taxation Code.

(4) "Business income" is as defined under Section 25120(a) of the Revenue and Taxation Code.

(5) "Combined report business income" is the business income of a member of a combined reporting group permitted or required to be included in the combined report of the group.

(6) "Total group combined report business income" is the sum or net of all combined report business income of all members of the combined reporting group.

(7) "Nonbusiness income" is the income of a member of the combined reporting group which is subject to allocation under Sections 25123 through 25127 of the Revenue and Taxation Code.

(8) "Apportionment" is the means by which total group combined report business income is sourced to this state under Sections 25128 through 25137 and Section 25141 of the Revenue and Taxation Code.

(9) "Taxpayer member's California apportionment percentage" ~~(Reserved)~~ refers to the fraction, determined under Section 25128 of the Revenue and Taxation Code, used to apportion the total group combined report business income to a taxpayer member in this state.

(10) "Member" is a single corporation in a combined reporting group. The term includes both taxpayer members and all other corporations included in the combined reporting group.

(11) "Taxpayer member" is a corporation which is a member of a combined reporting group which is required to file a tax return in this state.

(12) "Principal member" is the member of the combined reporting group whose accounting period is used as a reference period for all members of the combined reporting group to aggregate and apportion combined report business income of the group. A principal member need not be a taxpayer member.

(A) Once a principal member has been determined under this subsection (b)(12), that member shall remain the principal member for all succeeding periods that it is a member of the combined reporting group, except as permitted by the Franchise Tax Board. Except as otherwise provided, the "principal member" is the corporation first described below:

1. The parent corporation which is a member of the combined reporting group. A "parent corporation" is a corporation which is a parent corporation to all members of the combined reporting group, within the meaning of Section 25105(b)(1) of the Revenue and Taxation Code.

2. If the group does not have a parent corporation which is a member of the combined reporting group, as so defined, the "principal member" is a corporation which is a lower tier parent to all members of the combined report. A "lower tier parent" is the first corporation, down the chain of corporations, which is a member of the combined reporting group and which would have constituted a "parent corporation" to all members of the combined group if all corporations which own or constructively own that corporation under Section 25105(b)(1) of the Revenue and Taxation Code were disregarded.

3. If the group does not have a "lower tier parent" corporation which is a member of the combined reporting group, the "principal member" is the taxpayer member of the combined reporting group expected to have, on a recurring basis, the largest amount, by value, of real and tangible personal property in the state. The value of real and tangible personal property shall be determined pursuant to the property factor provisions of Sections 25129 through 25131 of the Revenue and Taxation Code and the regulations thereunder.

(B) Notwithstanding the provisions of preceding subsection (A) of this subsection (b)(12), in the first income year in which a combined report is required, the taxpayer members of the combined reporting group may elect to treat any other member of the combined reporting group as the "principal member," so long as consistently treated as such for the year of the election and thereafter. Thereafter, the taxpayer members may change their principal member only with consent of the Franchise Tax Board.

(C) In the event that members of a combined reporting group have filed with inconsistent principal members (including cases where two or more groups of corporations erroneously filed as distinct combined reporting groups) the determination of the appropriate principal member shall be in accordance with the provisions of subsection (A), unless, in the discretion of the Franchise Tax Board, selection of another principal member would result in a lesser compliance burden for the taxpayer members.

(13) "Group return" is that return filed on behalf of eligible electing taxpayer members of a combined reporting group included on the electing key corporation's Schedule R-7 of Schedule R filed in conjunction with its California Form 100.

(14) "Key corporation" is the taxpayer member which files a group return described by subsection (b)(13) of this regulation on behalf of the electing taxpayer members of the combined reporting group as agent and surety for the electing members.

(15) "Fiscalization" is the process under which a member of a combined reporting group aligns the income and apportionment data from its accounting period to the accounting period of the principal member.

(16) "California source carryover item" refers to an item of income or loss allocated or apportioned in an earlier year, required to be taken into account as California source income during the income year, other than a net operating loss.

(17) Unless the context otherwise requires, the term "income" includes loss.

(18) Except as otherwise provided, "total separate net income" is the total net income from all sources of a member of a combined reporting group from its separate books of account as determined under the Revenue and Taxation Code, before allocation and apportionment.

(19) "Corporation," as used in this regulation and other regulations under Section 25106.5 of the Revenue and Taxation Code, is any of the entities described as a corporation in Section 23038 of the Revenue and Taxation Code, including banks. In the application of Section

25102 of the Revenue and Taxation Code, the term "corporation" also includes "persons" as the term is used in that section.

(c) Steps in determining California source income or loss from the business income of a combined reporting group. ~~(Reserved).~~ Members of a combined reporting group shall compute their income from California sources in the following steps, in the order indicated.

(1) Except as otherwise provided by this regulation or other regulations adopted under Section 25106.5 of the Revenue and Taxation Code, each member of a combined reporting group must identify its total separate net income for the period beginning and ending with the accounting period of the principal member of the combined reporting group. Items of income and expense should be presented in columnar form for each member. Except as otherwise provided by this regulation or other regulations under Section 25106.5 of the Revenue and Taxation Code, total separate net income shall be determined by the Revenue and Taxation Code, subject to the following modifications:

(A) Adjustments with respect to transactions between members of a combined reporting group shall be determined under Section 25106.5-1 of the California Code of Regulations.

(B) Capital, Section 1231 (Internal Revenue Code), and involuntary conversion gains and losses shall not be taken into account. Such gains and losses are apportioned and allocated as determined under Section 25106.5-2 of the California Code of Regulations.

(C) Net operating loss deductions shall not be taken into account. The net operating loss deduction of a taxpayer member is allowed as a deduction only against the California source income (i.e., after apportionment and allocation) of the taxpayer member of the group (see subsection (d)(4) of this regulation).

(2) Except as otherwise provided by this regulation or other regulations under Section 25106.5 of the Revenue and Taxation Code, the taxpayer members of the combined reporting group may elect to determine the net income of a member of the group under accounting methods and other elections as authorized by Division 2, Part 11 of the Revenue and Taxation Code, independently of the net income of other members of the combined reporting group. See Section 25106.5-3 of the California Code of Regulations.

(3) The resulting total separate income of each member of the combined reporting group is then adjusted to remove income items attributable to the member's nonbusiness income, and any items of business income which do not relate to the combined report business income of the group.

(4) If the accounting period of the principal member and one or more of the other members of the combined reporting group do not begin and end on the same dates, adjustments must be made to fiscalize the other members' combined report business income and apportionment data to assign an appropriate amount of those values to the accounting period of the principal member in order for total group combined report business income to be apportioned. See Section 25106.5-4 of the California Code of Regulations.

(5) The combined report business income of all members, aligned to the accounting period of the principal member, is then aggregated, and the total of such income is adjusted to reflect application of the interest offset, determined under Section 25106.5-5 of the California Code of Regulations, resulting in total group combined report business income.

(6) Total group combined report business income for the accounting period of the principal member is multiplied by the California apportionment percentage of each of the taxpayer members of the group, determined under Section 25128 of the Revenue and Taxation Code, to arrive at each taxpayer member's California source combined report business income. That percentage is determined as follows:

(A) For most taxpayer members, the total group combined report business income is multiplied by the taxpayer member's California apportionment percentage consisting of the sum of the taxpayer member's California property factor, the payroll factor, and twice the sales factor, with that sum divided by four. However, if a combined reporting group has more than 50% of its gross business receipts from a qualified business activity, as defined in Section 25128 of the Revenue and Taxation Code and the regulations thereunder, the taxpayer member's California apportionment percentage consists of the sum of the taxpayer member's California property factor, payroll factor and sales factor, with that sum divided by three. In the determination of whether a single or double-weighted sales factor applies, the gross business receipts of the combined reporting group shall be determined on the basis of gross business receipts of the accounting period of the principal member, using the applicable fiscalization method provided in subsection (c)(4) of this regulation.

(B) In the application of subsection (c)(6) of this regulation, except as modified under Section 25137 of the Revenue and Taxation Code,

1. The taxpayer member's California property factor is a fraction, the numerator of which is that member's California property, and the denominator of which is the total property of the group everywhere. Property values are determined in accordance with Sections 25130 and 25131 of the Revenue and Taxation Code.

2. The taxpayer member's California payroll factor is a fraction, the numerator of which is that member's California payroll, determined under Section 25133 of the Revenue and Taxation Code, and the denominator of which is the total payroll of the group everywhere.

3. The taxpayer member's California sales factor is a fraction, the numerator of which is that member's California sales, determined under Sections 25134-25136 of the Revenue and Taxation Code, and the denominator of which is the total sales of the group everywhere. In the application of Section 25135 of the Revenue and Taxation Code, the term "taxpayer" refers to the specific member of the group which transferred title to tangible personal property to the purchaser. Thus, if a member of the combined reporting group sells goods shipped to a purchaser in California, and that member is not taxable in that state, the sale is not assigned to California, even if another member of the combined reporting group is taxable in that state. Likewise, if a taxpayer member sells goods to a purchaser in another state which are shipped

from California, and that member is not taxable in the other state, the sale is a California sale, even if another member of the combined reporting group is taxable in the other state. Except as otherwise provided, in the application of Section 25136 and sales factor provisions in Section 25137 (and the regulations respectively thereunder), for purposes of determining values in the numerator of the sales factor, the term "taxpayer" refers to the specific member of the group which was entitled to receive the proceeds of the sale.

(C) The taxpayer member's California apportionment percentage is the sum of that member's California payroll, property, and a double-weighted sales factor (or a single-weighted sales factor, if applicable), with that sum divided by either four or three, as determined under Section 25128 of the Revenue and Taxation Code and the regulations thereunder.

(D) Finally, each taxpayer member multiplies the group's total combined report business income by its respective taxpayer member's California apportionment percentage to arrive at the taxpayer member's California source apportioned income.

(7) If applicable, California source combined report business income of a taxpayer member, determined under subsection (c)(6) of this regulation, is then proportionately assigned to the applicable portion of that member's income year, based on the number of months falling within the common accounting period of the principal member. The resulting income from such portions is then aggregated (or netted) together for the member's income year to determine that member's business income from California sources attributable to the combined reporting group. (See Section 25106.5-4 of the California Code of Regulations.)

(d) Steps in determining a taxpayer member's income from sources within this state, for purposes of imposition of tax. (Reserved): The California source income of a taxpayer member of a combined reporting group subject to the imposition of the income or franchise tax is the sum (or net) of the member's California source business income; carryover items; capital, Section 1231 (Internal Revenue Code) and involuntary conversion gains and losses; and nonbusiness income. The resulting income is adjusted by the taxpayer member's California interest offset, charitable contribution adjustment and net operating loss deduction. The steps of that determination are as follows:

(1) To each taxpayer member's California source combined report business income, determined under subsection (c) of this regulation, is added (or netted) any other California source business income--

(A) Determined by apportionment of combined report business income of another combined reporting group of which the taxpayer is a member,

(B) From apportionment of income from a distinct business income activity conducted within and without the state wholly by the taxpayer member, or

(C) From a trade or business conducted wholly by the taxpayer member entirely within the state, if any.

(2) The amount determined under the preceding subsection (d)(1) is increased by or decreased by any--

(A) California source carryover items (see Section 25106.5-6 of the California Code of Regulations),

(B) California source income from the sale or exchange of capital or Section 1231 assets, and from involuntary conversions (see Section 25106.5-2 of the California Code of Regulations) and,

(C) California source nonbusiness income.

(3) The value determined under subsection (d)(2) of this regulation is reduced by the member's California interest offset, determined under Section 25106.5-5 of the California Code of Regulations, and the member's California source net operating loss carryforward deduction and increased or decreased by the taxpayer member's charitable contribution adjustment (see Section 25106.5-7 of the California Code of Regulations). The final resulting value is the taxpayer member's California source income.

(4) If after apportionment, allocation of nonbusiness items, and application of the member's California interest offset and charitable contribution adjustment (if applicable) the final resulting value of subsection (d)(3) of this regulation is a loss for a taxpayer member, that taxpayer member has a California source net operating loss (CSNOL). The CSNOL is subject to the net operating loss limitations and carryforward provisions of Sections 24416, 24416.1, 24416.2, 24416.3 and 25108 of the Revenue and Taxation Code. If applicable, the CSNOL must be recomputed to apply the Water's-Edge limitation of Section 24416(c) of the Revenue and Taxation Code. CSNOL, as adjusted, is applied as a deduction in a subsequent year only when the taxpayer has California source positive net income, whether or not the taxpayer is a member of a combined reporting group in the subsequent year. A CSNOL incurred by one member of a combined reporting group cannot be used to reduce the income of any other member in a subsequent income year. Whether the CSNOL resulted from an apportioned business loss or an allocated nonbusiness loss, or a combination of both, the CSNOL is a deduction against positive California source income in a subsequent year, regardless of the composition of that income as apportioned, allocated or wholly within California.

(e) ~~Steps in determining the taxpayer member's tax liability. (Reserved).~~ The taxpayer member's positive California source income, as determined under subsection (d), is multiplied by the applicable tax rate for the income year to arrive at the member's regular tax liability before tax credits.

(f) Years to Which this Regulation Applies. Except for subsection (c)(6) (and references to that subsection in other subsections of this regulation), this ~~This~~ regulation shall apply to income years open to adjustment under applicable statutes of limitation. Except for taxpayers which are members of a combined reporting group required to fiscalize their income, subsection (c)(6) shall apply to income years beginning on or after April 22, 1999. For taxpayers which are members of a combined reporting group required to fiscalize the income of its members to the accounting

period of the principal member, subsection (c)(6) shall apply to principal member accounting periods beginning on or after April 22, 1999. Combined reporting groups required to fiscalize the income of its members for income years beginning before April 22, 1999, may not designate a new principal member with a substantial purpose of avoiding application of subsection (c)(6).

Note: Authority Cited: Section 19503, Revenue and Taxation Code. Reference: Section 25106.5, Revenue and Taxation Code

**Section 25106.5-2 is amended to read:**

**§25106.5-2. Capital, Section 1231 of the Internal Revenue Code, and Involuntary Conversion Gains and Losses.**

(a) Gains or losses from the sale or exchange of a capital asset (or gains or losses treated as capital gains or losses under Subchapter P of Chapter 1 of Subtitle A of the Internal Revenue Code (hereafter also described as capital gains and losses)), property described by Section 1231(a)(3) of the Internal Revenue Code (Section 1231 property), or property subject to ~~a~~ an involuntary conversion shall be removed from the total separate net income of each member of a combined reporting group and shall be apportioned and allocated as provided in this regulation. Any remaining combined report business income shall be apportioned to the taxpayer members without regard to gains or losses described by this subsection. However, the effect of removal of such gains and losses from the total separate net income of the members shall not by itself have an effect upon the apportionment factors of the group or any of its members.

Example: Assume a member of a combined reporting group sells property that gives rise to a capital gain which constitutes a "sale" within the meaning of section 25120(e) of the Revenue and Taxation Code. That sale will be reflected in the sales factor (unless otherwise excluded by operation of Section 25137), notwithstanding the fact that the capital gains are subject to the special rules prescribed by this regulation.

(b) Before any netting of gains and losses from the sale or exchange of assets in the classes of long or short term capital assets, Section 1231 property, or property subject to an involuntary conversion, such gains and losses are classified as business income or loss, or nonbusiness income or loss, as the case may be.

(c) Each member's combined report business income resulting from gains and losses from the sale or exchange of capital assets, Section 1231 property, and involuntary conversions are then assigned to the accounting period of the principal member in accordance with the procedures of Section 25106.5-4(a) through (c) of the California Code of Regulations. All of the members' business gains and losses in each class are aggregated and then apportioned, before netting of gain or loss between classes, to each taxpayer member using the apportionment factors applicable to the rest of the members' combined report business income, to arrive at the taxpayer member's California source gain or loss, for the respective class of income or loss. The resulting California source gain or loss for each respective class is then adjusted to align such income to the income year of the taxpayer member to which it relates in accordance with the procedures of Section 25106.5-4(d) of the California Code of Regulations.

(d) Nonbusiness gains and losses from the sale or exchange of capital assets, Section 1231 property, and involuntary conversions which are allocated to California, and business gains and losses from such transactions which are apportioned to California (including business gains and losses from other combined reporting groups, if any), are then netted by each taxpayer member using the rules of Sections 1231 and 1222 of the Internal Revenue Code, without regard to any of the taxpayer member's ~~gain gains~~ or ~~loss losses~~ from the sale or exchange of capital assets, Section 1231 property, and involuntary ~~eversions~~ conversions ~~from any other state source~~ which are sourced to another state.

(e) Any California source net Section 1231 gain of a member produced in the application of the preceding subsection (d) shall be treated as California source ordinary income to the extent that the taxpayer member had California source Section 1231 losses in preceding income years, in accordance with the provisions of Section 1231(c) of the Internal Revenue Code.

(f) Any resulting California source income (or loss, if the loss is not subject to the limitations of Section 1211 of the Internal Revenue Code) of a taxpayer member produced by the application of the preceding subsections of this regulation shall then be applied to all other California source income or loss of that member.

(g) Capital Loss Carryforward ~~(Reserved)~~. Any resulting California source net capital loss, which is required to be carried forward under the rules of Section 1212, Internal Revenue Code, as modified by Section 24990.5, Revenue and Taxation Code, shall be treated by the taxpayer member as a California source short-term capital loss for the applicable member's income year of the carryover.

(h) This regulation shall apply to all income years open to adjustment under applicable statutes of limitation.

Note: Authority Cited: Section 19503, Revenue and Taxation Code. Reference: Section 25106.5, Revenue and Taxation Code